China

Hard blow

With the export sector hard hit by US tariff measures and private consumption growth weakening, investment growth has slowed. Although domestic demand could pick up in the short term, bolstered by monetary easing and fiscal stimulus measures, export prospects depend on the outcome of trade talks between Beijing and Washington, which remains highly uncertain. The authorities are bound to use foreign exchange policy sparingly to avoid creating a source of financial instability. Moreover, the current account surplus has improved again in recent months.

China's economic growth continues to slow. After decelerating for four quarters, real GDP growth remained stable at 6.4% year-on-year (y/y) in Q1 2019, but slowed again in Q2. The troubled export sector is the main reason for the slowdown, but domestic demand growth is also very sluggish.

The export sector is in shock

The increase in US tariffs on imports of Chinese goods has been a hard blow for exporters, especially since tariffs were raised at a time when world trade growth was already slowing. Trade tensions between the two countries and growing protectionism have had a direct impact on shipments of Chinese merchandise to the United States, but they have also begun to have an indirect impact on world demand, by eroding business confidence and investment. Tariff hikes have rapidly had a cascading effect on Asian supply chains as well.

Chinese export growth slowed from 14% y/y in H1 2018 to 8% in H2, before slipping slightly into negative territory in the first 5 months of 2019. Exports to the US, which amounted to USD 480 bn in 2018 (19% of Chinese exports), declined by 9% y/y in the first 5 months of 2019 according to China's General Administration of Customs (chart 2). US imports of Chinese goods that were hit by a 25% tariff hike as of July-August 2018 (about USD 50 bn) shrank rapidly following the US decision; their decline reached about 30% y/y in the first 4 months of 2019. Then the USD 200 bn of Chinese imports that were hit by a 10% tariff hike in September 2018, raised to 25% in May 2019, also contracted rapidly (following a rebound in Q3 2018 in anticipation of tariff increases): their decline reached more than 20% y/y in the first 4 months of the year, and the situation undoubtedly deteriorated in May-June.

Chinese exports to the rest of Asia (48% of exports) have also declined since December (-2% y/y), signalling the rapid transmission of US protectionist measures to other trading partners integrated in regional supply chains. Exports to Europe (19% of China's total exports) have continued to rise, but have nonetheless become less vigorous in the past six months, increasing by an average rate of only 7% y/y compared to 11% over the previous six-month period.

Private consumption growth slowing sharply

Private consumption growth has weakened. In April-May 2019, retail sales growth slowed to a new low of 7.9% y/y in value terms (vs an average of 9% in 2018) and 5.8% in volume (vs 7% in 2018). The

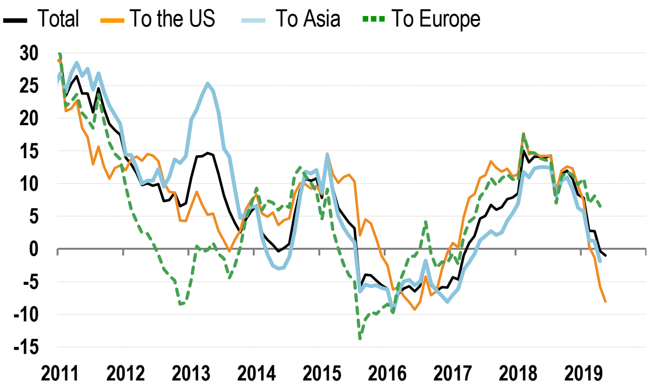
1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	6.8	6.6	6.2	6.0
Inflation (CPI, year average, %)	1.6	2.1	2.2	2.6
Actual fiscal balance / GDP (%)	-3.7	-4.2	-4.4	-4.5
Central government debt / GDP (%)	16.4	16.6	19.6	22.1
Current account balance / GDP (%)	1.6	0.4	0.1	-0.5
Total external debt / GDP (%)	14.4	14.5	14.0	14.0
Forex reserves (USD bn)	3 140	3 073	3 087	3 100
Forex reserves, in months of imports	17.0	14.5	14.5	14.0
Exchange rate USDCNY (year end)	6.5	6.9	6.9	6.7

e: BNP Paribas Group Economic Research estimates and forecasts

2- Exports falling

Exports of goods in USD, year-on-year % change, 6-month moving average



Source: China's General Administration of Customs

decline in automobile sales (-3% in 2018 and -13% y/y in January-May 2019) has had a heavy impact on the overall performance (automobiles account for about 10% of the total value of retail sales), but other sectors have also reported sluggish sales, notably durable goods (in line with the decline in real estate transactions) and leisure goods. Online sales growth has eased since H2 2018, but is still robust (+22% y/y in the first 5 months of 2019). Consumption of services is also still dynamic (it is estimated to account for nearly half of total consumer spending) but seems to be slowing more significantly in recent months.

The poor performance of private consumption is worrying because it delays the process of rebalancing the economy at a time when China is facing very unfavourable external conditions. The sluggishness of Chinese consumers is partially due to the troubles in the export sector and its consequences on confidence and the labour market. As a matter of fact, the "jobs" sub-component of the manufacturing PMI published by the National Bureau of Statistics has deteriorated rapidly since September 2018. In June 2019, it hit a low of 46.9 compared to an average of 48.9 in 2017-2018.

Consumer price inflation accelerated to 2.6% y/y in May-June 2019 from an average of 2.3% in 2018 and 1.6% in 2017. Inflation is mainly driven by a rapid increase in food prices over the past 3 months (+6.9% y/y in April-May, compared to an average of 1.8% in 2018). Meanwhile, core inflation declined slightly from 1.8% y/y at the end of 2018 to 1.6% in May 2019, a sign of sluggish domestic demand. Inflationary pressures are unlikely to hamper the accommodating bias of monetary policy in the short term, but they will constrain households' real income. The increase in per capita disposable income already slowed last year, dropping from 7.3% in real terms in 2017 to 6.5% in 2018, and standing at 6.8% y/y in Q1 2019.

The slowdown in private consumption growth can also be blamed on the weaker expansion in real estate loans and consumer credit. This has resulted from a still relatively tight property policy, from the strengthening in financial-sector regulation implemented since late 2016, and from repressive measures introduced more recently to reduce the number of P2P platforms for loans between individuals. At the same time, the household debt burden has increased in recent years and may well have begun to strain consumption. Household debt accounted for 53% of GDP at the end of 2018, up from 49% at year-end 2017 and 33% at year-end 2013.

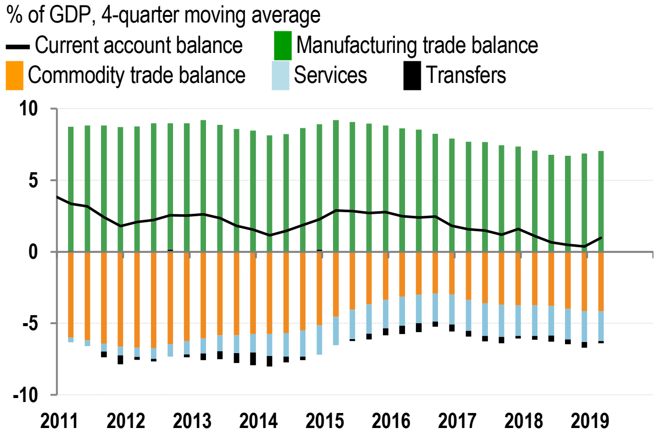
In response to the slowdown in exports and private consumption, investment growth also decelerated in the first 5 months of the year, notably in the manufacturing sector (3.2% y/y in value, compared to 6.2% in 2018).

The economic growth slowdown is expected to continue in the very short term. Export prospects remain very uncertain given the major disagreements between Washington and Beijing, even though trade talks are due to resume. As to domestic demand, the main factors behind the slowdown in private consumption are still in place. Soon, however, spending of households and corporates should begin recovering, bolstered by fiscal stimulus measures launched since early 2019 and by the ongoing but prudent easing of the credit policy.

Moderate deterioration in external accounts

China is bound to maintain a prudent foreign exchange policy. Over the past year, the authorities have responded to the increase in US tariffs by letting the yuan weaken against the dollar (by 9.1% between end-March and end-December 2018, and then by 2.5% in May 2019). These bouts of depreciation have helped partially offset the impact of tariff hikes on exports. Although more could follow, they are bound to be moderate in scope, temporary and followed by slight re-appreciation movements. An overly rapid depreciation of the yuan risks triggering periods of financial instability and capital outflows, which Beijing would rather avoid.

3- Current account surplus persisting



Source: SAFE

Moreover, recent dynamics in China's external accounts have tended to reduce the downward pressure on the yuan. After shrinking rapidly in 2018, the trade surplus has begun to swell again since early 2019 (USD 131 bn in the first 5 month of the year, compared to USD 102 bn in the same period of 2018) despite the poor export performance. Imports contracted more sharply given the reduced need for industrial inputs, sluggish domestic demand and the decline in commodity prices.

The services balance continues to show a major deficit due to the solid momentum of Chinese tourism abroad, but it has levelled off at close to 2% of GDP since last year. All in all, the current account surplus picked up slightly in Q1 2019 after contracting from 1.6% in 2017 to 0.4% in 2018 (chart 3). As to the financial account, net capital flows have been relatively stable since early 2019. Foreign exchange reserves have increased slightly, reaching USD 3100 bn at the end of May 2019.

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